Credit Risk

Pre-CRR3 AFME position paper

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In recent years the European Commission has sought to develop a Capital Markets Union in order to reduce the reliance of corporates and SMEs and infrastructure projects on bank funding. In the EU, banks provide 70% of the funding while just 30% comes from capital markets. This is in stark contrast to other regions such as the US where the inverse is the case. While efforts to develop a CMU are ongoing, it is therefore essential that regulations not only promote a sound financial system, but also take full account of potential adverse impacts on both banking and capital market developments, which operate in tandem, and do not adversely affect the funding of the European economy. This is particularly important in the context of credit risk, where the Basel III December 7 agreement significantly overhauled the standardised (SA) and advanced (AIRB) approaches banks take to lending.

We think the revised Basel credit risk framework introduces several changes, which not only could challenge the Basel commitment to no overall significant increase in capital, but could also have a major impact on banks' ability to fund the real economy, if not carefully implemented. Most notably in supplying working capital to corporates and supporting their daily treasury functions, which are not funded through capital markets issuance. Indeed, we consider the overall impact of moving from the advanced approach to the foundation approach for several exposure classes is a regressive step in terms of assessing risk, especially given the SSM's review of internal models (TRIM) exercise, benchmarking, and the IRB repair work undertaken by the EBA. Some of the proposed changes could even risk introducing new causes of unjustified variability in IRB banks' risk weights and are not addressed by the soon to be finalised EBA IRB repair programme. It is vital that these changes are clarified before inclusion in the revised CRR3, and/or as necessary revise relevant EBA Guidelines and RTS to provide the required clarity.

Below we have set out our concerns on how the final Basel III agreement will impact banks in relation to the financing of EU corporates, the operationalisation of the new rules, and unintended consequences.

1. <u>Financing of Corporates</u>

Given the limited progress on developing a Capital Markets Union to date and the reliance of the EU's corporate market on bank financing, we would urge regulators to be mindful of this in the implementation of the Standardised Approach (SA) alongside the Output Floor. Compared to the current framework, the implementation of Basel III will have a significant impact for banks that currently use IRB to calculate capital requirements for unrated corporates which are deemed investment grade. While the 100% risk-weight (RW) for unrated corporates under the SA remains 100%, per the External ratings-based Approach (ERBA), the introduction of the Output Floor raises the effective RW for banks using IRB. As the majority of EU corporate exposures are unrated this could, all other things being equal, result in financing becoming more expensive for the EU corporate sector. AFME's view is that the same capital requirements should be applied to borrowers of equivalent risk regardless of the rating approach used. Failing this, companies of equivalent risk potentially face different financing costs.

Furthermore, the recent analysis undertaken by the EBA as part of the Call for Advice exercise comparing the ERBA with the Standardised Credit Assessment Approach (SCRA) was based on proxy data to estimate the impact for IRB banks. This showed that at least 10% of investment grade unrated corporates (based on this proxy data) would be subject to a higher RW of 100% under the ERBA, compared to 65% under the SCRA. However, this analysis fails to take account of the main consequential impact of the output floor for banks using IRB to calculate capital requirements for unrated corporates. Hence, as the Commission undertakes its impact analysis for CRR3, we urge it to consider this interaction in order to ensure the same capital requirements are applied to borrowers of equivalent risk irrespective of the methodology used to assess such risk, and consult on this in advance of its CRR3 proposals.

In respect of minimising the impact of the SA on corporate financing through a more appropriate risk sensitive framework, we would urge legislators to reflect on the risk associated with **short term exposures.** Namely, RWs in the SA don't take into account short maturity as they do under the IRB maturity adjustment factor, which reflects short-term maturity as a risk mitigant. Only in case of Exposures to Banks with original maturity < 3 months is a favourable RW is permitted. No such favourable RW is take into account in the Corporate exposure class in Basel III. This will also significantly impact on capital markets transactions such as SFTs, which are normally short-term exposures of < 1year and therefore the RW is counterintuitive given the shorter - and thus safer - duration, and the overall SFT business. Legislators should therefore consider aligning the RWs for short-term exposures (e.g. for corporates) with that for banks with a < 3-month maturity.

Application of F-IRB LGDs to exposures to Large Corporates: In addition to the challenges the SA presents in terms of financing corporates, banks will be significantly impacted in respect of their exposures to Corporates (and financial institutions) when they move from applying the AIRB to the FIRB. The 45/40% LGDs in the future framework will impact the provision of day to day banking services for corporates, which is often made of undrawn credit facilities that cannot be replaced by capital markets issuance. If this remains unchanged then there are a number of other aspects of corporate financing that could be considered to alleviate some of the impact set out in this paper.

The move from AIRB to FIRB also presents an operational challenge in respect of the **application to corporates above a €500million threshold** which is introduced in the revised standard**.** Under Basel III banks will no longer be able to model their risk parameter (such as LDG & EAD) to corporates that belong to a group with total consolidated annual revenues greater than €500mn, this is to be assessed on average amounts over the prior three years or on the latest amounts updated every three years by the bank. The expectations for how banks evidence this will be significant, as it will have a material impact on data requested from clients (in particular non-listed clients). Banks will also be required to apply the foundation approach and use supervisory estimates for the LGD, EAD and Maturity. Consequently, banks will likely have to redesign some of their corporate models in order to comply with the new scope of application. Given that it can take at best 1-2 years for models to be approved it is not clear how this new requirement will interact with banks' building of models that include corporates that are close to this threshold – legislators should consider further guidance on this in the rules to ensure smooth implementation.

Furthermore, the requirement to assess it on the consolidated revenues means that stand-alone corporates (for which banks can use the IRBA) may get better financing terms than corporates that are part of a large parent company despite presenting the same risk to the bank in terms of lending. This is also inconsistent with current EBA GLs for LGD estimation where banks are required to use all available relevant internal data to estimate LGD and therefore include data for mid-sized corporates which are part of a larger group. In a similar vein, when it comes to modelling LGDs, some national competent authorities stated banks are required to use 20 observations per country and collateral type – this change could reduce risk sensitivity of RWA in the country because observations of mid-size entities which are part of a large group would be removed. In this context it should also be noted that the Dec 2017 BCBS text indicates that specialised lending loans are not included within the scope of the corporate threshold as the Corporate asset class comprises two sub asset classes (article 38 of d424 text page 12), the General Corporate one and the specialised lending one, the threshold only applies to the General Corporate asset class (article 34, (i) page 59).

Corporates will be impacted by the application of the 2.5 year fixed maturity in the FIRB: Given the far wider scope of application of the FIRB under Basel III to large corporates and financial institutions, the requirement to apply the fixed maturity of 2.5 years should be given due consideration. Basel III reflects on this by incorporating a national discretion which would allow competent authorities to use the cash-flow method under the AIRB. This discretion should be adopted as EU-wide to promote risk sensitivity.

Finally, as EU legislators have consistently recognised, SME's are the backbone of the European economy and the SME supporting factor plays a crucial role in banks' offering competitive financing to this sector of the economy. **The full scope of the SME SF as agreed in CRR2 should therefore be maintained** for both the SA and IRBA as it will ensure stability of prudential treatment of SMEs over time.

2. Operational challenges

It is important for globally active banks that international standards are implemented on a consistent timeline across jurisdictions, including transitional arrangements, and with a reasonable implementation period for banks to implement the revised requirements and allow adequate time for supervisors to complete the model approval process once the legislative process is finalised. Many firms currently have a significant pipeline of models awaiting regulatory approval, at the same time, some of these models may be subject to decommissioning due to the move from advanced to foundation approaches or require substantial changes (and therefore entailing model change notifications/ approvals to the regulator). The operational challenges for implementing the revised standardised and advanced approach are set out in further detail below.

Application of the FIRB to financial institutions will adversely impact use of credit insurance products: with the increase expected in RWs as a result of the restricted use of internal models, banks will continue to use, if not increase, credit insurance to mitigate the impact on RWs in the final Basel III framework. However, due to the fixed level of LGD (45%) under the F-IRB which banks will have to apply to financial counterparties such as insurers, this approach is likely to be hindered. It should be recognised that benefiting from an insurance policy is not the same risk as being a creditor to an insurer. Indeed, the Solvency II regime ensures preferential treatment of insurance policy holders. Hence in the case of an insured deal the bank taking it out would be treated as super senior, hence a 45% LGD would be an overstatement. Besides this, in the instance where the insured part of a loan benefits from an asset collateral from credit insurance, if the insurer has not fully indemnified the lenders, these insured loans keep the benefit of the asset in security which has to be reflected in RWAs. We note that from the June 2006 BCBS text through to the Dec 2017 BCBS revised BIII text, all are silent on the treatment of deals which benefit from both a guarantee or an insurance and an asset in collateral. Therefore, we propose that for RW calculation banks have the option to take into account the PD of the insurer and the LGD related to the secured transaction if lower than that of the insurer, as the lenders retain full security over the asset in the case of the insurer defaulting. The LGD of the secured transaction should be kept in A-IRB as the fact that there is an insurance should not change the modelling of the collateral asset.

The F-IRB LGD could have wide reaching unintended consequences for the unfunded credit protection, given the majority of protection providers are financial institutions (insurers or banks). Moreover, it is important that insurance remains a way for banks to continue their role of structuring of loans in a European market which relies on bank financing. Reducing the use of internal models for corporates together with the new F-IRB constraint on insurers could lead to bank financing of corporates going down. The same issue of 45% F-IRB for banks guarantees would apply in case sub-participation in risk on a loan by a third-party bank.

Another concern regarding banks is the consistency of the application of a 45% LGD and the LGD levels used in other regulatory streams such as BRRD. Industry experience shows that the proposed level of 45% LGD is located within the highest range of LGDs for banks. See also CRM clarifications.

Data availability and quality: The implementation of the revised standardised approach will require significant changes to the data infrastructure. For example, at the product level, the identification of exposures eligible for the new 'transactor' treatment will require historical payment behaviours to be analysed. Indeed, we would recommend the definition of 'transactor' be adapted and simplified to suit European financing activities. This could include enlarging the scope to capture financing in some jurisdictions which has the same features as credit cards. For example, a revolving credit line of credit that is not attached to a credit card should be recognized as a 'transactor' transaction (if it has the same characteristics).

In addition, the RW add-on for currency mismatch for mortgage and retail exposures will require data not yet captured, which will need a permanent monitoring of the currency's income, even where the wide majority of exposures will not be affected by this add-on. New processes will need to be established to feed the correct data into the regulatory reporting and management information systems. Given the large number of retail portfolios on the standardised approach, this will be a significant effort. Enough time should be allowed for the systems and process changes to be implemented, where necessary through transitional entry into force timelines. Indeed, the calculation of LTV in the new standardised approach for real estate exposures as well as the identification of buy-to-let exposures will be additional challenges. Furthermore, guidance should be supplied on how any historical data gaps can be managed, including through data pooling.

IFRS 9: The implications of the IFRS 9 standard and the double counting of expected loss in capital between IFRS9 and the standardised credit risk weights should be reviewed. Amendments to eliminate the double-counting should be made to the risk weights ahead of implementation of the Basel rules, so that they are included in Pillar 1, rather than being left to Pillar 2.

Defaulted exposures: The RWA treatment of defaulted exposures should be reviewed in light of the Pillar 1 backstop for Non-Performing Loans ('NPLs') – due to be introduced in the EU in Q1 2019 – to ensure that the treatment is appropriate. At the very least, we would expect that the EU will exercise the discretion to reduce the risk weight to 50% when specific provisions are no less than 50% of the outstanding amount of the loan. Furthermore, guidance should be provided on how the defaulted exposures regime applies to defaulted exposures purchased at a discount, where specific provisions are not raised but an element of expected and unexpected losses have been absorbed by the purchase price.

Credit Risk mitigation: The Basel III framework will require a number of changes to how banks use credit risk mitigation (CRM) techniques. It is important that legislators reflect on the EBA work to develop Guidelines on CRM framework to ensure this is consistently reflected in the CRR3 approach.

There are also several uncertain aspects for which greater clarity is needed so that banks can implement in their internal approaches to CRM:

- **PD input floor:** Clarification is required as to whether the PD floor of 0.05% will also apply in the context of PD substitution for guarantees received. Furthermore, paragraph 66 of the Basel agreement states the floor doesn't apply to Sovereign exposures, early confirmation of this approach would be welcomed (N.B. Paragraph 1.5.1 of the most recent BCBS Consultation clarifies that BCBS standards "retains the main features of Basel II" and which would also therefore confirm the absence of input floors.)
- **Double default:** The joint probability of default of an underlying obligor and a protection provider is smaller than the individual default by either party. This should continue to be reflected in the capital framework, for the different forms of unfunded credit protection which can be used to mitigate credit risk exposures. Examples include corporate or bank guarantees received in support of bank lending (both the obligor and the guarantor must default prior to a loss risk), or issuance of a Confirmation on Export Documentary Credits (both the Importer and the Issuing Bank must default prior to a loss risk), and Trade Credit Insurance policies which function in a manner similar to a guarantee received from an insurer. Removing double default from the choices for calculation of credit risk mitigation ignores the inherent diversification benefit where the probability of default of an obligor is not correlated to the probability of default of a security provider.
- **On-Balance Sheet netting (OBSN**) – The Basel 3 text requires OBS is recognised in EAD under all approaches and removes the ability for AIRB banks to recognise in LGD estimates. Improvements could be made to the drafting of the CRR in this area as it has led to different interpretations amongst banks on how to recognise OBSN under the AIRB approach. We support the Basel 3 change as recognition via EAD, as it better relates to this type of CRM.
- CRR is silent on how **unfunded credit protection (UFCP) for specialised lending exposures** should be treated under the CRM framework. UFCP should be recognised for specialised lending treated under supervisory slotting via inclusion of a risk weight substitution method similar to that under the Standardised approach.
- The calculation of the LGD input floors uses formula which requires institutions to use the haircuts under foundation approach and consequently means the collateral will need to be eligible under the F-IRB. This will significantly restrict the scope of eligible collateral compared to the current A-IRB framework for the purpose of the calculation of the LGD floor.

3. Unintended Consequences

The final Basel III standard introduces a number of substantive changes to the way in which banks operate which could result in unintended consequences, not least in the knock-on effect for the calculation of the output floor which will be a binding constraint for a number of banks and limit their scope to finance certain products, markets and business lines. It is therefore important to address unintended outcomes which may not reflect the appropriate risk sensitivity associated with certain types of lending. Areas which should be considered are set out in further detail below.

Loan to Values: The proposed use of the origination valuation for calculation of loan-to-values ('LTVs') for property exposures could be misrepresentative as it reflects the property market at an arbitrary point in time. In this respect it is not as predictive of true mark-to-market values, particularly in falling markets when banks are more likely to be under stress. The use of origination valuation means loans which are re-mortgaged during their lifetime (with the same or different lenders) will have different LTV values as a result of rising house prices or falling house prices. The LTV, risk weight and therefore capital requirement for the same loan could be different depending on whether it is re-mortgaged during its lifetime or not – this despite all other risk characteristics of the loan remaining unchanged. It should also be noted that in some Member States LTV is not considered in the borrowers' repayment capacity, rather it is the loan to income ratio. To address this issue, legislators should consider using a mark-to-market valuation unless a genuinely anti-cyclical valuation method can be devised.

Real estate loan-splitting: Loan-splitting techniques, which allow different part of a facility to be risk weighted differently are best left at the discretion of the institution, and not determined by supervisors. Furthermore, loan-splitting should also be enhanced to increase the levels of granularity by increasing the number of risk weights to be comparable with those under the non-loan splitting approach.

Acquisition, Development and Construction (ADC) exposures: ADC loans are not necessarily speculative ones as lenders require pre-sales or pre-leases. In some jurisdictions these pre-sales are binding contracts that cannot be cancelled by the purchaser. Furthermore, an amount of equity is brought, which ensures that the break-even price is much lower than the grid price, i.e. there would be no loss for the lenders even with a substantial reduction of price. This non-speculative ADC activity would be unduly penalized by the standardized approach on which the output floor will be based. Consequently, the prudential treatment to pre-lease and pre-sales conditions for residential real estate (100% RW instead of 150% RW) should be enlarged to commercial real estate.

Unconditionally Cancellable Commitments: the introduction of a 10% CCF for UCCs will impact on end users, as banks look to cover the increased cost of capital. Affected facilities will include trade related products, such as documentary letters of credit and bank facilities that are necessary to provide liquidity for international trade. The national discretion as set out in Footnote 53 (Paragraph 78) to exempt certain arrangements where certain conditions are met should be exercised at an EU level. This footnote should also apply to overdrafts (retail or financial) and financial counterparties given they are common counterparties in trade financing and as the conditions are related to the characteristics of the potential bank offer and should therefore apply to any type of counterpart. Furthermore, regulators should note the changes could lead to misalignment of accounting versus risk as some UCCs as defined under Basel may be considered 'UCC' but are not accounted for as off-balance sheet.

Maintain 20% CCF for trade related contingent items: In the first CRR (as agreed 2014) this was set at 20% (as opposed to 50% CCF in Basel). In current political climate more important than ever that European banks remain active in financing global trade and the low-risk nature of trade finance continues to be recognised.

Replacement of EAD modelling with the Standardised CCF's for all non-revolving financing commitments. As the Basel "footnote 53" of the SA recognises to an extent, the SA CCFs are likely to have an impact on real economy end users. In addition, increasing the scope of SA CCFs will have knock on impact for the LR in determining the leverage exposure for off balance sheet items. CCF modelling for all financing commitments should therefore be maintained.

Commitments and contingent facilities are an important tool for corporate treasurers to manage their liquidity and deal with unexpected delays or demands in payments. If credit conversion factors no longer reflect the real likelihood of drawing on commitments, they may be mispriced and their usefulness as a tool for corporates could be reduced. This is notably the case for technical guarantees which SA CCF would appear overstated.

Specialised lending: It is welcome that Basel III recognises the non-standardised nature of SL and continues to allow the AIRB approach for SL exposures. Nonetheless, there are several aspects of the SL treatment which need to be addressed to ensure this remains a viable asset class for banks to finance in Europe. In particular, the RWs need to closely reflect banks' appetite for risk and quality, and legislators need to ensure that there is enough risk sensitivity built in for lower risk transactions. It is also important to maintain the Infrastructure Support Factor - this will help lending to some SL financing but not compensate for the overall high increase in RWs for SL in particular in the SA.

Under the standardised approach the risk weights do not fully take into account security packages and covenants which allow for control over future cash flows**.** Greater granularity should be considered to reflect the quality of the project, transactions, contractual structure, LTVs (where appropriate for the SL sub-sector) and structuring features (e.g. reflecting self-liquidating trade related exposures). The eligibility criteria should also be adapted.

For the advanced approach the LGD floor levels are too high for the best quality and collateralised transactions. We note that the application of these LGD input floors to SL were not consulted on or subject to an impact assessment before the publication of the final text in December 2017. We would therefore urge regulators to consider refining the Basel input floor formula which needs to reflect the quality and collateral of transactions, in particular the 40% haircut on collateral asset values which is not consistent with the decision of the BCBS to allow banks to continue using internal models for SL.

Finally, it should be noted that the perimeters of the SA and IRB are different – under the SA specialised lending does not include exposures to real estate. This should be aligned with the IRB which does include IPRE and HVCRE.

AFME has prepared a separate detailed position paper on how to refine the Basel III proposals on SL to better reflect the quality and risk of transactions.

Equity investments: Under Basel III equity exposures fall under the standardised approach. This change was not subject to an impact assessment and is not aligned with current CRR IRB- simple method treatment for private equity of 190%. The current risk-weighting applied to an investment in a well-diversified portfolio of equity investments on a standardised basis is currently 150%. Under the new Basel approach this will increase to a minimum of 250% (+67%) for equity exposures generally, and to 400% for venture capital exposures (+167%). Furthermore, the definition of venture capital is ill-defined both by Basel and current EU legislation and could lead to the highest increases in risk-weights being applied very broadly across this asset class. Such increases in risk-weights could have a significant knock on effect for the development of the Capital

Markets Union. The definition of "venture capital" should therefore be aligned with the recent EBA guideline issued on January 2019 that clarify that: "*this includes exposures to firms that provide funding to newly established enterprises (e.g. funding for the development of a new product and for the related research for the enterprise to bring this product to the market, and funding for the build-up of the production capacity of the enterprise or for the expansion of the business of the enterprise).*"

Securities financing transactions: There could be unintended consequences for SFTs as the scope in the Basel III framework[1] is overly broad and it could capture transactions that are important to the overall market functioning through which banks source securities for market making and client short facilitations. It is therefore essential that banks are still permitted to use internal models approach in the calculation of EAD and own estimates for collateral haircuts for repo-style transactions and other similar SFTs.

In addition, the treatment under the comprehensive approach of SFTs covered by master netting agreements that are legally enforceable should fully recognise the effect of netting. The formula in paragraph 178 should be adjusted by removing the amount based on the gross exposure. This formula should only include the net exposure and an amount for currency mismatch. Regulators should also consider that the use of the formula in paragraph 178 to should apply to all SFT transactions such as margin lending, not just repo-style transactions. Indeed, the most recent BCBS Consultation paragraph 1.4.3 clarifies the treatment of margin lending transactions under the comprehensive approach. Our understanding of this is that the treatment of SFTs covered by master netting agreements in paragraph 175 to 178 should cover both repo-style transactions and margin lending transactions.

Sovereign exposures: it should be noted that the Basel committee made no reflection on the treatment of sovereign exposures in their final position. Therefore, we would not recommend the EU take any unilateral measures to change the treatment of sovereign exposures.

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